Are Non-GAAP Measures Helpful or Harmful?

09.27.2016

U.S. Generally Accepted Accounting Principles (GAAP) are a set of rules and procedures that accountants typically follow to record and summarize business transactions. These guidelines provide the foundation for consistent, fair, honest and accurate financial reporting. Private companies generally aren’t required to follow GAAP, but many do. Public companies don’t have a choice; they’re required to follow GAAP.

Over the years, the use of non-GAAP measures has grown. These unaudited figures can provide added insight when they’re used to supplement GAAP performance measures. But they can also be used to mislead investors and artificially inflate a public company’s stock price. Here’s more on this controversial trend — and why it’s led to a backlash from some business groups and regulators.

Non-GAAP measures can sometimes mislead investors

Some investors and executives argue that unaudited performance figures, such as earnings before interest, taxes, depreciation and amortization (EBITDA), provide a more meaningful proxy of financial performance than net income as defined in U.S. GAAP. In recent years, however, some companies have manipulated EBITDA figures by excluding certain costs. This trend has made it difficult for analysts to do fair comparisons and understand the items taken out.

Some companies include these EBITDA figures, along with other non-GAAP measures that cast the company in a favorable light, in the management, discussion and analysis (MD&A) section of their financial statements, earnings releases and investor presentations. These unaudited figures may be cherry-picked to present a stronger financial picture than the ones that appear in their audited financial statements. In turn, these companies often see their stock prices go up when the earnings are announced three to four weeks before audited financial statements are filed with the Securities and Exchange Commission (SEC).
Business groups join in

The widespread use of EBITDA has long been the subject of skepticism from investors and regulators. Recently, however, a coalition of more than a dozen corporate and financial industry executives called on companies to rein in their use of non-GAAP measures. The executives included the demand in an open letter entitled “Commonsense Corporate Governance Principles.” The six-point letter covers several areas of corporate governance, including calls for greater corporate board independence and diversity and less focus on quarterly results.

Executives specifically criticized a tendency to exclude stock- or options-based compensation from non-GAAP earnings. “All compensation, including equity compensation, is plainly a cost of doing business and should be reflected in any non-GAAP measurement of earnings in precisely the same manner it is reflected in GAAP earnings,” the letter said.

SEC updates Regulation G

During her keynote address at the International Corporate Governance Network Annual Conference in June, SEC Chair Mary Jo White reiterated her concerns about the use of unaudited performance figures: “In too many cases, the non-GAAP information, which is meant to supplement the GAAP information, has become the key message to investors, crowding out and effectively supplanting the GAAP presentation.”

She identified a number of troublesome practices that can make non-GAAP disclosures misleading, such as a lack of equal or greater prominence for GAAP measures, individually tailored non-GAAP revenues, lack of consistency and the use of cash per share data. She urged audit committees to revisit their approach to non-GAAP disclosures to ensure transparency, consistency and comparability. (See “Questions About Non-GAAP Measures for Audit Committees.”)

Just before her keynote speech, the SEC had updated its Compliance and Disclosure Interpretations (C&DI) for non-GAAP information, laying out the circumstances under which the market regulator could crack down on the figures. While certain adjustments aren’t explicitly banned by the SEC, an adjustment may amount to a violation of Rule 100(b) of Regulation G if it results in a misleading presentation of non-GAAP measures. Regulation G, which went into effect in 2003, set forth disclosure requirements for issuers that use non-GAAP financial measures.

PCAOB project on non-GAAP measures

The Public Company Accounting Oversight Board (PCAOB) has also been reviewing input through its advisory groups about whether auditors should provide some sort of assurance on non-GAAP metrics. Given that the measures move the stock markets, some investors believe auditors should at least review key measures to make sure they are presented fairly.
Some members of the PCAOB’s Standing Advisory Group have suggested that the audit regulatory board tighten the rules around the “read and consider” aspect of auditing that deals with “other information” outside the financial statements. They want auditors to evaluate the consistency of the information within and outside the financial statements. Currently, some non-GAAP information is found in press releases or elsewhere and not considered “other information.”

**Stay tuned**

It remains unclear if the SEC will crack down on the use of non-GAAP figures — or if the PCAOB will change the auditing standards for public companies — given the varying views among investors about the best regulatory responses. But one thing is certain: Non-GAAP measures are under greater scrutiny, so companies that decide to disclose such information should exercise caution and avoid making claims that could potentially mislead investors.

**PLUS:** The Center for Audit Quality compiled a checklist of possible questions for audit committees to ask management and external auditors before using non-GAAP metrics. Click here to view.

Do you have questions about whether non-GAAP measures are helpful or harmful to your organization? Contact Dan Ward, Principal, Audit Services, at 314.983.1237.